No. 91-1822

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

LA ISLA VIRGEN, INC.,

Petitioner,

v.

ANTHONY P. OLIVE, Director of Virgin Islands Bureau of Internal Revenue, and GOVERNMENT OF THE VIRGIN ISLANDS,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the courts below correctly determined that Petitioner did not meet its burden of proving that it should not be subject to negligence penalties.

2. Whether the penalty for substantial underpayment of income taxes provided in section 6661 of the Internal Revenue Code may be imposed on a United States person that resides in the United States Virgin Islands.

3. Whether sections 1277(c)(2)(B)(ii) and 1277(c)(2)(E) of the Tax Reform Act of 1986 prevent the Virgin Islands from taxing Petitioner on certain income that is exempt from United States tax under section 1277(c)(2)(E) of such Act.

4. Whether the district court below erred in its determination that a certain sale of property occurred after the property was transferred to Petitioner and that Petitioner was therefore taxable on the gain from the sale.

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Petitioner,

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ANTHONY P. OLIVE, Director of Virgin Islands Bureau of Internal Revenue, and GOVERNMENT OF THE VIRGIN ISLANDS,

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF IN OPPOSITION

Respondents, Anthony P. Olive, Director of the Virgin Islands Bureau of Internal Revenue (hereinafter, "the VIBIR"),[1] and the Government of the Virgin Islands, oppose the Petition for a Writ of Certiorari. The Petition raises no issue worthy of review by this Court.

Respondents do not challenge Petitioner's assertions under the headings Opinions Below, Jurisdiction,

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[1] Anthony P. Olive has been succeeded in office by Edward E. Thomas.

and Statutes Involved. Respondents do challenge portions of Petitioner's Statement of the Case. Therefore, Respondents submit their own Statement of the Case.

STATEMENT OF THE CASE

Respondents generally agree with the facts set forth in Petitioner's Statement of the Case.[2] Respondents believe, however, that the Court would benefit from a more detailed explanation of the legal context in which this case arises than is provided in Petitioner's Statement. Respondents also believe that Petitioner has misstated certain facts relating to its alleged reliance on counsel. Accordingly, this statement is provided.

Petitioner was incorporated in the State of Delaware on March 6, 1981, by William M. Lansdale (hereinafter, "Lansdale"), a United States individual.[3] (Pet. 3.[4]) Although Petitioner has conducted some business in the Virgin Islands (Pet. App. 60a), most of Petitioner's income for the years in issue (Petitioner's taxable years ended February 28, 1982, February 28,

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[2] The factual portion of Petitioner's Statement of the Case begins on the top of page three of the Petition and ends with the first full paragraph on page six of the Petition.

[3] Petitioner's capital stock actually was issued to William M. Lansdale and Marianthi K. Lansdale, husband and wife, as community property. (Pet. 4, n.1.) Throughout this brief, references to "Lansdale" are intended to include both William and Marianthi Lansdale, when appropriate.

[4] "Pet." references are to the Petition for a Writ of Certiorari. "Pet. App." references are to the Appendix to the Petition. "Resp. App." references are to the Appendix to this Brief in Opposition.

1983, February 29, 1984, February 28, 1985, and February 28, 1986) consisted of gains from sales of property located in the mainland United States. During the years in issue, Petitioner reported approximately $19.97 million of income from non-Virgin Islands sources (most of which was attributable to sales of property located in the United States). (Pet. App. 18a-19a.)

At the time Petitioner filed its income tax returns for the years in issue, a United States corporation doing business in the Virgin Islands (such as Petitioner) was obligated to pay taxes into the Virgin Islands treasury pursuant to two statutes.

The first statute was § 1 of the Naval Service Appropriation Act, 1922, Act of July 12, 1921, ch. 44, § 1, 42 Stat. 123 (1921) (codified, as amended, at 48 U.S.C.S. § 1397 (Law. Co-op. 1981 & Supp. 1989)),[5] which established the "mirror" tax system. Under the mirror system, the U.S. Internal Revenue Code (hereinafter, the "I.R.C.") is applied in the Virgin Islands in "mirrored" form (hereinafter, the "mirror code") by substituting the words "Virgin Islands" for the words "United States". *E.g., Vitco, Inc. v. Government of the Virgin Islands*, 560 F.2d 180, 180-82 (3d Cir. 1977), *cert. denied*, 435 U.S. 980 (1978). Under the mirror code, Petitioner was treated as a foreign corporation and was obligated to pay taxes to the Virgin Islands on its Virgin Islands source income and its income that was effectively connected with a Virgin Islands trade or business. I.R.C. §§ 881 and 882 (mirrored).

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[5] References to § 1 of the Naval Service Appropriation Act are to such section as in effect for the years in issue.

The second statute was § 28(a) of the Revised Organic Act of the Virgin Islands, Act of July 22, 1954, ch. 558, § 28(a), 68 Stat. 508, (codified, as amended, at 48 U.S.C.S. § 1642 (Law. Co-op. 1981 & Supp. 1989)) (hereinafter, "ROA § 28(a)" or "the inhabitant rule").[6] ROA § 28(a) directed a U.S. corporation qualifying as an "inhabitant" of the Virgin Islands to satisfy its U.S. income tax obligations by paying its tax under the I.R.C. to the Virgin Islands. ROA § 28(a) provided, in pertinent part:

> [T]he term "inhabitants of the Virgin Islands" as used in this section shall include all persons whose permanent residence is in the Virgin Islands, and *such persons shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands*. . . .

ROA § 28(a) (emphasis added). The parties agree that, for the years in issue, Petitioner was an "inhabitant" of the Virgin Islands within the meaning of ROA § 28(a). (Pet. 3; Pet. App. 16a.)

At the time Petitioner filed its returns for the years in issue, the effect of the inhabitant rule was the subject of differing interpretations. According to a "tax haven theory" propounded in the Tax Management, Inc., portfolio *Business Operations in the U.S. Virgin Islands*, authored by Virgin Islands lawyer/

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[6] References to § 28(a) of the Revised Organic Act of the Virgin Islands are to such section as in effect for the taxable years in issue.

accountant Gustav A. Danielson ("Danielson"), the inhabitant rule permitted a U.S. corporation that qualified as a Virgin Islands inhabitant to avoid paying *any* tax, to either the United States or the Virgin Islands, on its non-Virgin Islands source income that was not effectively connected with a Virgin Islands trade or business.[7]

The VIBIR and the Internal Revenue Service, on the other hand, took the position that the inhabitant rule required such a corporation to pay to the Virgin Islands the same tax it would pay if it were a domestic Virgin Islands corporation.[8]

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[7] Danielson, 336-2nd T.M., *Business Operations in the U.S. Virgin Islands* (1985). The theory was based on the following two arguments (*see Bizcap, Inc. v. Olive*, 892 F.2d 1163, 1166 (3d Cir. 1989), *cert. denied sub nom. Caribbean Marine, Inc. v. Olive*, 496 U.S. 905 (1990)):

1. Under the inhabitant rule, a U.S. corporation qualifying as a Virgin Islands inhabitant satisfied its entire U.S. income tax obligation simply by filing a tax return with the Virgin Islands and paying to the Virgin Islands the corporation's tax *as determined under the mirror code*.

2. Under the mirror code, a U.S. corporation was not subject to Virgin Islands tax on non-Virgin Islands source income unless that income was effectively connected with a Virgin Islands trade or business because, for mirror-code purposes, a U.S. corporation was a "foreign corporation." I.R.C. §§ 881 and 882 (mirrored).

In *Danbury, Inc. v. Olive*, 820 F.2d 618, 625 (3d Cir. 1987), *cert. denied*, 484 U.S. 964 (1987), the Third Circuit pointed out that Danielson's Tax Management Portfolio (at p. A-91) described this interpretation of the inhabitant rule as a "tax haven theory."

[8] *See Danbury*, 820 F.2d at 620 (setting forth the VIBIR's position), and Rev. Rul. 80-40, 1980-1 C.B. 175 (setting forth the Internal Revenue Service's position).

Petitioner filed its returns for 1982-86 on the basis of Danielson's tax haven theory. It reported non-Virgin Islands source income of nearly $20 million for this period but paid no tax on that income. (Pet. App. 18a-19a.)

On May 13, 1986, following examinations of Petitioner's 1982 and 1983 returns, the VIBIR issued to Petitioner the first of a series of statutory notices asserting tax deficiencies and penalties. For the period 1982-1986, the asserted deficiencies and penalties totaled $8,729,927 and $1,991,154, respectively. (Pet. 3; Pet. App. 16a.)

On October 22, 1986, Congress repealed the inhabitant rule by enacting § 1275(b) of the Tax Reform Act of 1986 (hereinafter, "TRA 86"), Pub. L. 99-514, § 1275(b), 100 Stat. 2085, 2598 (1986) (codified at I.R.C. § 7651(5)(B) (CCH 1991). Under the new law, "a corporation such as Danbury [*i.e.*, a U.S. corporation qualifying as a Virgin Islands inhabitant] pays its taxes under the mirrored Code to [the VIBIR] and pays its taxes under the [I.R.C.] to the Internal Revenue Service." *Danbury, Inc. v. Olive*, 820 F.2d 618, 625 (3d Cir. 1987), *cert. denied*, 484 U.S. 964 (1987).

The generally applicable effective-date provision, TRA 86 § 1277(c)(2), 100 Stat. 2601, made the repeal both prospective (*i.e.*, applicable to taxable years beginning after 1986) and partially retroactive (*i.e.*, applicable to certain taxable years beginning before 1987, referred to in the statute as "pre-1987 open years"). Petitioner, however, received a "targeted" exception (*i.e.*, an exception applying only to Petitioner) from the retroactive application of the repeal of the inhabitant rule, through TRA 86

§ 1277(c)(2)(E), 100 Stat. 2601. (Pet. App. 32a.) Petitioner's exception states:

> (E) EXCEPTION FOR CERTAIN TRANSACTIONS.
>
> (i) IN GENERAL. In the case of any pre-1987 open year, the amendment made by section 1275(b) shall not apply to [certain income derived by Petitioner].[9]

On June 5, 1987, the United States Court of Appeals for the Third Circuit decided *Danbury*, 820 F.2d 618, rejecting Danielson's tax haven theory and holding that, under the plain language of the inhabitant rule (as in effect prior to its repeal)—

> Danbury owed the [VIBIR] (1) Virgin Islands taxes on Virgin Islands-generated income, under the Naval Appropriations Act [*i.e.*, the mirror code], and (2) U.S. taxes on worldwide income, figured with a tax credit for any Virgin Islands or other foreign taxes paid, under Section 28(a).

Danbury, 820 F.2d at 623.

On July 21, 1986, January 11, 1988, and August 5, 1988, Petitioner filed petitions in the District Court

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[9] The exception does not actually refer to Petitioner by name, but refers to "any income derived from transactions described in clause (ii) by 1 or more corporations which were formed in Delaware on or about March 6, 1981, and which have owned 1 or more office buildings in St. Thomas, United States Virgin Islands, for at least 5 years before the date of the enactment of this Act." TRA 86 § 1277(c)(2)(E)(i), 100 Stat. 2601. The parties agree that this language refers to Petitioner and that the "transactions described in clause (ii)" are the transactions at issue in this case. (Pet. App. 32a.)

of the Virgin Islands for redetermination of the tax deficiencies asserted against it by the VIBIR. (Pet. 3.) The district court consolidated the actions by Order dated April 12, 1990.

In view of the Third Circuit Court of Appeals' holding in *Danbury*, Petitioner did not argue in the proceedings below that Petitioner's non-Virgin Islands source income was exempt from Virgin Islands taxation by reason of ROA § 28(a). (*I.e.*, Petitioner did not argue that Danielson's tax haven theory was correct.) Instead, Petitioner argued that such income was exempt from Virgin Islands taxation by reason of TRA 86 § 1277(c)(2)(E), Petitioner's targeted exception to the retroactive repeal of the inhabitant rule. (Pet. App. 8a.) Petitioner also argued, inconsistently with the form of its transactions and its reporting of those transactions, that certain of the income did not belong to Petitioner. (Pet. 22.)

The district court below, relying on *Bizcap, Inc. v. Olive*, 892 F.2d 1163 (3d Cir. 1989), *cert. denied sub nom. Caribbean Marine, Inc. v. Olive*, 496 U.S. 905 (1990), rejected Petitioner's argument and held that (i) TRA § 1277(c)(2)(E) simply treated Petitioner, for the taxable years in issue, as though the inhabitant rule had not been repealed, and (ii) under the court of appeals' holding in *Danbury*, the inhabitant rule required Petitioner to pay tax to the Virgin Islands on Petitioner's income from all sources.[10] (Pet. App.

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[10] In *Bizcap*, 892 F.2d 1163, the Third Circuit Court of Appeals had reached the identical conclusion with respect to another corporation, which was the beneficiary of another targeted exception to the retroactive repeal of the inhabitant rule, set forth in TRA 86 § 1277(c)(2)(D), 100 Stat. 2601.

5a-8a.) The district court observed that the drafters of TRA 86 § 1277(c)(2)(E) could have stated explicitly that Petitioner was exempt from tax liability on its U.S. source income for the years in issue, but did not do so. (Pet. App. 8a.)

The district court also rejected Petitioner's argument that certain of the income Petitioner had reported did not belong to Petitioner. (Pet. App. 9a.)

Finally, the district court sustained the penalties imposed on Petitioner by the VIBIR under I.R.C. §§ 6651(a) (relating to failure to file a timely return), 6653(a) (relating to negligence or disregard of rules and regulations), and 6661(a) (relating to substantial understatement of income tax). With respect to the negligence penalty, Petitioner had taken the position that "it was not negligent because it relied on advice of its legal counsel in determining its tax liability." (Pet. App. 10a.) Respondents, on the other hand, had argued that Petitioner had not produced evidence that it *reasonably* relied on competent counsel, pointing out that Petitioner had "sought the opinion of the author of the '28(a) tax haven theory' whose advice and predisposition were known from the 'portfolio.' " (Resp. App. 6a.) The district court made no finding that Petitioner had reasonably relied on counsel in determining its tax liability,[11] noted that "the tax-

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[11] The Petition erroneously refers to "the stipulation that [Petitioner] relied on advice of its legal counsel in determining its tax liability, which precludes imposition of penalties for negligence." (Pet. 7.) There is no such stipulation in the record. The parties stipulated only that Danielson, who had been retained by Lansdale, analyzed Lansdale's income tax situation, architected the various transactions in issue, and provided two opinion letters, dated September 25, 1981, and June 25, 1982,

payer has the burden of proving the absence of negligence" (Pet. App. 10a), and sustained the penalty.[12]

On December 17, 1991, the Court of Appeals for the Third Circuit affirmed the judgment of the district court, without opinion (Pet. App. 1a),[13] and on January 14, 1992, the Court of Appeals for the Third

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regarding the tax consequences of the transactions. (Pet. App. 34a-35a.) The parties did not, however, stipulate that Petitioner relied on Danielson's advice in determining Petitioner's tax liability. In fact, it is difficult to see how Petitioner could have concluded that it owed no tax to the Virgin Islands on the basis of Danielson's advice, since Danielson's September 25, 1981, letter identified substantial grounds for expecting the Third Circuit to reject the tax haven theory. (*See* Pet. App. 76a-77a.)

Moreover, Rufus Rhoades, Lansdale's regular attorney and a tax expert able to exercise independent judgment, never advised Lansdale or Petitioner that the tax haven theory was correct, but merely "concluded that the . . . theory was sufficiently valid to make it worthwhile pursuing." (Pet. App. 29a.)

Thus, the parties did not stipulate, and the district court did not find, that Petitioner relied on the advice of counsel in determining its tax liability.

[12] Respondents' principal argument in the district court in connection with the I.R.C. § 6653(a) penalty was that Petitioner should be found liable for the penalty because Petitioner intentionally disregarded rules and regulations. (Resp. App. 3a-6a.) The district court, however, stated: "This record does not support a finding of intentional disregard of rules or regulations." (Pet. App. 10a.)

[13] On appeal to the Third Circuit, Respondents requested the court of appeals to reverse the district court's determination that the record did not support a finding of intentional disregard of rules or regulations. (Resp. App. 11a-14a.) Respondents also reiterated their assertion that Petitioner had not proven that it reasonably relied on counsel. (Resp. App. 15a-16a.)

Circuit denied Petitioner's petition for rehearing and for rehearing *en banc*. (Pet. App. 12a-13a.)

This Petition for a Writ of Certiorari followed.

REASONS FOR DENYING THE WRIT

A. The Decision Below Raises No Issue Worthy of Review by This Court

This case involves nothing more than an attempt by William M. Lansdale, a United States individual taxpayer, to avoid paying any tax on United States source income by means of a now-discredited tax-shelter scheme utilizing the so-called tax haven theory of Virgin Islands taxation promoted by lawyer/accountant Gustav Danielson.

The Petition itself reveals that, to implement Danielson's tax haven theory, and utilizing Danielson's services, Lansdale (i) created Petitioner, (ii) transferred to Petitioner an interest in California real estate in a tax-free exchange, (iii) caused Petitioner to dispose of that real estate, and (iv) caused Petitioner to report the resulting gain as tax-free income to the VIBIR, all for the purpose of avoiding tax. (Pet. 4-6; Pet. App. 29a.) Moreover, in furtherance of this tax avoidance plan, (i) Lansdale paid no tax on the gain (Pet. App. 28a), and (ii) relying on the tax haven theory, Petitioner paid no tax on the gain. (Pet. App. 18a-19a.) Then, after the Third Circuit held in *Danbury*, 820 F.2d 618, that the tax haven theory was contrary to the plain language of ROA § 28(a), and after the Third Circuit held in *Bizcap*, 892 F.2d 1163, that the targeted exception in TRA 86 § 1277(c)(2)(D) did not exempt its beneficiary from Virgin Islands taxes, Petitioner attempted to disavow the unambig-

uous and consistently reported form of the transactions at issue (namely, a tax-free contribution of property by Lansdale to Petitioner, followed by a taxable disposition of that property by Petitioner), arguing that Lansdale, and not Petitioner, should have reported, and paid tax on, the gain from those transactions.[14] The courts below properly rejected all of Petitioner's arguments, and there is no basis for this Court to review their decisions.

In its attempt to persuade this Court to review the decisions below, Petitioner vainly seeks to portray this case as something other than a routine tax shelter case.

First, Petitioner attempts to characterize the decisions below as "[resurrecting] a strict liability theory of tax negligence once characterized by the Third Circuit as 'an inconceivable proposition'" (Pet. 12), when in fact the courts below simply held that Petitioner had not met its burden of proving that Petitioner was not negligent.

Second, Petitioner attempts to persuade this Court that the penalty provisions in the I.R.C. do not apply in the Virgin Islands, disregarding all contrary authority and relying solely on Petitioner's novel and preposterous proposition that Congress established a taxing system in the Virgin Islands without *any* procedural and administrative rules. (Pet. 13-14.)

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[14] Under I.R.C. § 6501(a), the statute of limitations for Lansdale's most recent return for the period in issue expired on April 15, 1990, unless Lansdale and the Internal Revenue Service agreed to extend the statute of limitations under I.R.C. § 6501(c)(4). The record does not show that Lansdale and the Internal Revenue Service have entered into such an agreement.

Third, Petitioner argues that the VIBIR has no authority to collect Petitioner's taxes, relying on a clearly erroneous interpretation of a provision of TRA 86 that does not even apply to Petitioner. (Pet. 17.)

Fourth, Petitioner argues that it should be permitted to avoid tax by (i) disavowing its entire role in the tax-shelter transaction for which it was created, inconsistently with its own reporting of the transaction (Pet. 21), and (ii) rejecting the findings of fact in the district court below.

When Petitioner's meritless arguments are stripped away, there is no issue in this case that warrants this Court's consideration.

B. There Is No Basis for This Court To Disturb the Determination of the Courts Below That Petitioner Did Not Meet Its Burden of Proving That It Was Not Negligent

Petitioner mischaracterizes the decisions below when it asserts that "to leave undisturbed the Third Circuit's summary affirmance would resurrect a strict liability theory of tax negligence . . . ." (Pet. 12.) In fact, there are substantial grounds in the record, having nothing to do with a "strict theory of tax negligence," for the Third Circuit's affirmance of the district court's judgment, and Petitioner's only cause for complaint is that the court of appeals did not explain its decision in an opinion, a complaint that does not merit this Court's consideration.

In the district court proceedings below, the VIBIR argued that the court should sustain the penalties asserted under I.R.C. § 6653(a) for either of two reasons: first, because Petitioner had intentionally disregarded Rev. Rul. 80-40, 1980-1 C.B. 175 (Resp. App.

4a-7a); second, because Petitioner could not reasonably rely on an opinion from Danielson, who was the promoter of the tax haven theory and could not render independent advice (Resp. App. 8a-9a). The VIBIR did not argue that Petitioner was negligent because Petitioner relied on negligent counsel—in fact, the VIBIR did not even assert that Danielson was negligent.

The district court sustained the penalty on grounds that are, frankly, unclear. (*See* Pet. App. 10a.) First, the district court correctly noted that "[t]he taxpayer has the burden of proving the absence of negligence . . ." and observed that "[Petitioner's] position is that it was not negligent because it relied on advice of its legal counsel in determining its tax liability." As the cases cited by Petitioner make clear, a taxpayer taking this position has the burden of proving that it *reasonably* relied on advice of counsel. *See, e.g., Hanson v. Commissioner*, 696 F.2d 1232, 1234 (9th Cir. 1983). The district court, however, made no finding of reasonable reliance. The court also stated: "[I]f its legal counsel were negligent, [Petitioner] would be liable under this section," but this was mere dictum since the court had made no finding that Petitioner reasonably relied on counsel in determining Petitioner's tax liability. The court then added: "There is no showing that [Petitioner's] counsel was other than negligent." Finally, the court stated that the record did not "support a finding of intentional disregard of the tax rules or regulations."

On appeal to the Third Circuit, the VIBIR did not argue that the district court's decision should be affirmed because Petitioner's counsel was negligent, nor did the VIBIR even assert that Danielson was neg-

ligent. Instead, the VIBIR asked the court of appeals to take plenary review of the district court's holding and determine that Petitioner intentionally disregarded rules and regulations. (Resp. App. 16a.) In this regard, the VIBIR argued that the district court had ignored *Business Ventures International v. Olive*, 893 F.2d 641 (3d Cir. 1990), in which the Third Circuit had previously determined that disregard of Rev. Rul. 80-40 is a sufficient basis for sustaining the penalty under I.R.C. § 6653(a). (Resp. App. 17a.) The VIBIR also repeated its position that it was not reasonable for Petitioner to rely on Danielson's opinions due to Danielson's status as the "promoter" of the tax haven theory. (Resp. App. 19a-21a.) On this record, the Third Circuit affirmed the *judgment* of the district court, without issuing its own opinion or adopting the opinion of the district court.

In sum, the basis for the district court's decision below is unclear, and there is no reason to assume that the court of appeals below affirmed the district court's decision on the basis of a "strict theory of tax negligence." At the same time, the VIBIR provided the court of appeals with two substantial grounds, having nothing to do with Danielson's possible negligence, for affirming the district court decision. Accordingly, the determination that Petitioner is liable for the penalty under I.R.C. § 6653(a) is not worthy of review by this Court.

C. Under the Plain Language of the Applicable Statutes and All of the Relevant Case Law, the Penalty for Substantial Underpayment of Income Taxes Provided in Section 6661 of the Internal Revenue Code May Be Imposed on a United States Person That Resides in the United States Virgin Islands

I.R.C. § 6661(a) provides:

> ADDITION TO TAX.—If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 25 percent of the amount of any underpayment attributable to such understatement.

Petitioner argues that the VIBIR has no authority to impose the penalty provided by I.R.C. § 6661(a). Petitioner argues that (i) I.R.C. § 6661 is part of Subtitle F of the Internal Revenue Code, (ii) Subtitle F of the Internal Revenue Code does not apply in the Virgin Islands, and (iii) the only procedural and administrative tax laws applicable to income taxation in the Virgin Islands are those rules found in Part II of Subtitle 1 of Title 33 of the Virgin Islands Code. (Pet. 14-15.) Petitioner's argument is devoid of merit and does not warrant this Court's attention.

The mirror system of taxation in the Virgin Islands became law in *1921*. Under the mirror system, "an individual or corporation in the Virgin Islands pays taxes to the [VIBIR] equivalent to the taxes an individual or corporation under the same circumstances in the United States would pay to the Internal Revenue Service," *Danbury*, 820 F.2d at 620. ROA § 28(a) became law in *1954*. Under ROA § 28(a), a Virgin Islands inhabitant must pay to the VIBIR "taxes owed under applicable provisions of the non-mirrored In-

ternal Revenue Code." *Danbury*, 820 F.2d at 623. Part II of Subtitle 1 of Title 33 of the Virgin Islands Code, 33 V.I.C. §§ 701 *et seq.*, on the other hand, was not enacted until *1957*.[15] Under Petitioner's position, therefore, there were absolutely no procedural and administrative laws applicable to Virgin Islands income taxation from 1921 to 1957![16]

Petitioner's only argument in support of this position is the unsupported assertion that the procedural and administrative rules in Subtitle F of the Internal Revenue Code are not "applicable taxing statutes" within the meaning of ROA § 28(a) (Pet. 13) or "income tax laws" within the meaning of the Naval Services Appropriation Act. (Pet. 14.) Petitioner cites absolutely no authority for these arguments. In fact,

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[15] Title 33 of the Virgin Islands Code was enacted by the Virgin Islands Legislature by Act No. 160, section 1, approved May 16, 1957.

[16] The procedural and administrative rules in Subtitle F of the Internal Revenue Code, which Petitioner asserts are not applicable in the Virgin Islands (except to the extent such rules are adopted by the Virgin Islands as local laws), include, among other things (i) all rules relating to the obligation to file income tax returns (Chapter 61),.(ii) all rules relating to the payment of income taxes (Chapter 62), (iii) all rules relating to assessment and collection of income taxes (Chapters 63 and 64), (iv) all rules relating to abatements, credits, and refunds of income taxes (Chapter 65), (v) all applicable statutes of limitations (Chapter 66), (vi) all rules relating to interest on underpayments and overpayments (Chapter 68), (vii) all rules relating to penalties (Chapter 68), (viii) all rules relating to closing agreements and compromises (Chapter 74), (ix) all rules relating to criminal income tax offenses (Chapter 75), (x) all rules relating to judicial proceedings in connection with income taxes, and (xi) all definitions of terms used in the Internal Revenue Code (Chapter 79).

no court has ever suggested that, prior to the enactment of Title 33 of the Virgin Islands Code, a taxpayer that would be subject to income tax penalties and interest under the I.R.C. could avoid payment of those penalties and interest simply because the taxpayer's income tax was owed to the Virgin Islands. Indeed, the "equality principle" articulated by the Third Circuit in *Chicago Bridge and Iron Co. v. Wheatley*, 430 F.2d 973, 975, n.2 (3d Cir. 1970), *cert. denied*, 401 U.S. 910 (1971), compels the conclusion that an inhabitant taxpayer must pay to the Virgin Islands the same penalties that it would pay to the United States if it were not an inhabitant.[17]

Moreover, the District Court of the Virgin Islands has held expressly that provisions in Subtitle F of the I.R.C. apply in the Virgin Islands. In *U.S. Virgin Islands v. Bank of America*, 17 V.I. 594, 595-96 (D.V.I. 1980), the district court held that I.R.C. § 7609 (which is contained in Subtitle F) applies in the Virgin

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[17] Ironically, Petitioner refers to footnote 2 of *Chicago Bridge and Iron Co.*, 430 F.2d 973, as support for Petitioner's position. That footnote observes, in dictum, that "Part II [of Title 33, Subtitle 1, of the Virgin Islands Code] comprises procedural and administrative provisions applicable to all Virgin Islands taxes, including the United States income tax." (Pet. 15.) The dictum is generally accurate, but, to the extent the rules in Title 33 of the Virgin Islands Code apply to the United States income tax, it is only because the same provisions are contained in the Internal Revenue Code, which applies in the Virgin Islands under the mirror system and the inhabitant rule. As the district court held in *U.S. Virgin Islands v. Bank of America*, 17 V.I. 594, 596 (D.V.I. 1980), the legislature of the Virgin Islands does not have the authority to determine which provisions of the I.R.C., "as it applies to income taxes," will be adopted in the Virgin Islands.

Islands even though it has not been enacted as part of Title 33 of the Virgin Islands Code. The court stated:

> Petitioners would read in an exception not apparent on the face of the Naval Appropriations Act, arguing that the provisions of Subtitle F of the Internal Revenue Code does (sic) not apply to the Virgin Islands. Further, argue petitioners, the Legislature of the Virgin Islands has not enacted § 7609 as a part of Title 33 of the Virgin Islands Code and that by reason of the failure of the Legislature of the Virgin Islands so to do, [the] would-be intervenors [in this case] can derive no benefit from the provisions of that section. This argument seems to the Court to be flawed in many respects . . . .

Finally, Petitioner is erroneous in asserting that "respondents' position leads to the absurd result that a Virgin Islands taxpayer is subject to Internal Revenue Code procedural and administrative provisions on United States source income and subject to the procedural and administrative provisions contained in Title 33, Part II (sic) of the Virgin Islands Code on its Virgin Islands source income." (Pet. 13) In fact, Respondents' position is that Subtitle F of the I.R.C. is applicable to all income taxes imposed in the Virgin Islands under the mirror code, and the rules in Title 33, Subtitle 1, Part II, Virgin Islands Code (other than those rules that accurately restate the rules in Subtitle F of the I.R.C.) are applicable only to Virgin Islands taxes other than income taxes.

D. Sections 1277(c)(2)(B)(ii) and 1277(c)(2)(E) of the Tax Reform Act of 1986 Do Not Prevent the Virgin Islands From Taxing Petitioner on Certain Income That Is Exempt From United States Tax Under Section 1277(c)(2)(E) of Such Act

When Congress repealed the "inhabitant rule" by enacting TRA 86 § 1275(b), Congress granted two targeted exceptions to the retroactive application of that provision. The exception set forth in TRA 86 § 1277(c)(2)(D) applies to a taxpayer called "Bizcap". *See Bizcap, Inc. v. Olive*, 892 F.2d at 1167. The exception set forth in TRA § 1277(c)(2)(E) applies to Petitioner. (Pet. App. 32a.) The two exceptions are identical except for the descriptions of the taxpayers and transactions to which they apply. Each exception states that, as to the taxpayer or transactions to which the exception applies, "In the case of any pre-1987 open year, the amendment made by section 1275(b) shall not apply . . . ."

In *Bizcap*, the Third Circuit Court of Appeals held that (i) the language quoted above simply treated Bizcap, for all pre-1987 open years, as though the inhabitant rule had not been repealed, and (ii) under the court of appeals' holding in *Danbury*, 820 F.2d 618, the inhabitant rule required Bizcap to pay tax to the Virgin Islands on Bizcap's income from all sources. The Supreme Court subsequently rejected Bizcap's petition for a writ of certiorari. 496 U.S. 905 (1990). In the decision below, the district court simply followed the holding in *Bizcap*, noting that "[Petitioner] now makes the same argument that Bizcap made and which the third circuit has already rejected." (Pet. App. 8a.) The decision below is correct, this Court has already rejected a petition for a writ

of certiorari in an identical case, and there is no basis for the Court to reach a different conclusion in this case.

In light of the decisions in *Bizcap*, Petitioner argues that (i) TRA 86 § 1277(c)(2)(B)(ii) (a provision not addressed in *Bizcap*) "deprived the Virgin Islands of the right to collect the tax revenue generated by the retroactive repeal [of the inhabitant rule] by providing that only taxes paid to the Virgin Islands on or before the date of enactment would be credited against the taxpayer's liability to the United States with respect to non-Virgin Islands source income" (Pet. 17), and (ii) the Third Circuit's decision in *Bizcap* was wrong because the court did not consider this point in deciding that case. (Pet. 19.)

Petitioner's argument is singularly unfounded. Not only does Petitioner mischaracterize the purpose and effect of TRA 86 § 1277(c)(2)(B)(ii), that provision does not even apply to Petitioner! Both of these points are quite simple. Since TRA 86 § 1275(b) repealed the inhabitant rule retroactively for all taxable years not barred by the statute of limitations, it followed that, the moment the statute was enacted, Virgin Islands inhabitants with United States source income in "open" years owed taxes to the United States on that income. Many of those taxpayers, however, had already paid taxes on that income to the Virgin Islands (individuals residing in the Virgin Islands, for example). TRA 86 § 1277(c)(2)(B)(ii) (which is reproduced at Pet. App. 48a-49a) simply allowed such taxpayers to credit the tax payments they had already made to the Virgin Islands against their newly created, retroactive tax liabilities to the United States. TRA 86 § 1277(c)(2)(B)(ii) does nothing more than pro-

vide a credit against tax owed to the United States and has nothing whatsoever to do with either the determination of any tax owed to the Virgin Islands or the VIBIR's power to collect such tax. Moreover, since TRA 86 § 1277(c)(2)(B)(ii) provides a credit only against taxes owed to the United States *by reason of the retroactive repeal of the inhabitant rule*, it cannot possibly apply to Petitioner, which is exempted from such United States taxes by TRA 86 § 1277(c)(2)(E).

E. There Is No Basis for This Court to Disturb the Determination of the District Below That a Certain Sale of Property Occurred After the Property Was Transferred to Petitioner and That Petitioner Was Therefore Taxable on the Gain From the Sale

Petitioner urges that it cannot be liable for tax on gain from a sale of certain California real estate because (i) Petitioner was inserted into the sale transaction "only to take advantage of the perceived benefit that would be available to it" under the tax haven theory, and (ii) Petitioner did not participate in a meaningful way in the sales negotiations. (Pet. 21.) Petitioner theorizes that, under these facts, the courts below erred when they failed to hold that the "step transaction" and "assignment of income" doctrines protected Petitioner from tax. (Pet. 19-22.) In pursuit of this theory, Petitioner proposes to disavow its entire role in the transactions for which it was created as well as its consistent reporting of those transactions on its tax returns. (Pet. 21.)

Petitioner's arguments are utterly without merit.

Petitioner was created by Lansdale as part of a tax-avoidance scheme, and all of the transactions involved in this case were carefully designed so that the income generated by the transactions would be

Petitioner's income and not Lansdale's. Consistently with the tax avoidance purpose and actual form of the transaction, Petitioner reported the income from the transactions, while Lansdale did not. (Pet. 4-6, Pet. 21; Pet. App. 28a-29a; Pet. App. 35a.) Petitioner even prevailed upon the Congress of the United States to grant Petitioner an exemption from U.S. taxation of the income from those transactions (Pet. App. 32a.), an exemption that would have been meaningless if the income were not Petitioner's. All of this was done solely because Lansdale hoped to pay no tax on millions of dollars of income. Now, when Petitioner's meticulously constructed tax shelter has failed, Petitioner seeks to persuade this Court that the courts below violated "long settled principles of income tax law" (Pet. 19.) by holding Petitioner to the consistently reported form of its transaction. There is no precedent that permits a taxpayer to avoid tax by disavowing the chosen form of a tax avoidance transaction, and Petitioner's argument is not worthy of consideration by this Court.[18]

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[18] Petitioner argues that, in this case, the taxpayer should be permitted to disavow the form of its transaction because the VIBIR has "opened the recharacterization door" by treating the integrated creation/redemption of Petitioner's interest in the partnership acquiring the real estate as a "disguised sale." (Pet. 22-23.) In support of this proposition, however, Petitioner cites only a law journal article. *See* Smith, "Substance and Form: A Taxpayer's Right to Assert the Priority of Substance," 44 *Tax Lawyer* 137, 172-73 (Fall 1990). Moreover, Petitioner fails to refer to the following crucial passage from the discussion in that article:

> [A] taxpayer should not be permitted to use the [Internal Revenue] Service's application of the substance over form principle as an excuse to

Moreover, even if Petitioner were not bound by the form of its transaction, the decisions below would still be correct, because the substance-over-form doctrines Petitioner cites do not apply to this case.

First, although Petitioner argues that the district court failed to undertake "a proper step transaction analysis" (Pet. 20), the step transaction doctrine is simply irrelevant to the question of whether Petitioner is taxable. It is of course true that the transfer of property by Petitioner to a newly formed partnership in exchange for a 24-percent partnership interest, coupled with the simultaneous redemption of 23/24 of that partnership interest for cash and notes (*see* Pet. 21), constituted "interrelated yet formally distinct steps in an integrated transaction [that] may not be considered independently of the overall transaction." *See Commissioner v. Clark*, 489 U.S. 726, 738 (1989), quoted at Pet. 20. Thus, the step transaction doctrine was properly applied to disregard the transitory acquisition and redemption of the partnership interest. On the other hand, Petitioner's prior acquisition of the transferred property was anything but transitory. In that prior transaction, Petitioner acquired valuable

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> impeach form in ways not reasonably related to the Service's position .... The test ... should seek to distinguish between a defensive taxpayer position and a taxpayer position which uses the Service's claim merely as an excuse for impermissible post-transactional tax planning.

Id., at 173. In this case, the only function of Respondent's "recharacterization" of Petitioner's partnership transaction is to treat Petitioner's income as ordinary income rather than capital gain. Thus, Petitioner's post-transactional attempt to escape taxation completely by disavowing its entire role in the transaction would be rejected by the very commentator cited by Petitioner.

property from Lansdale as a capital contribution (Pet. App. 25a), and, after Petitioner exchanged that property for cash and notes in the integrated partnership transaction described above, Petitioner retained ownership of the cash and notes.

Second, there is no basis for Petitioner's argument that, "under the assignment of income doctrine and long established precedents of this Court, petitioner is not properly liable for tax with respect to [the income from the California real estate transactions]," citing *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and *Waltham Netoco Theatres, Inc. v. Commissioner*, 401 F.2d 333 (1st Cir. 1968).[19] (Pet. 21.) Those cases, which require a corporation to pay tax on gain from a sale of property *by the corporation* even though, in form, the property is conveyed by the corporation to its shareholders who then convey the property to the purchaser in exchange for the purchase price, do not apply to Petitioner. In *U.S. v. Cumberland Public Service Co.*, 338 U.S. 451 (1950), this Court held that *Court Holding Co.* does not control where, as a matter of fact, the sale is made by the shareholders rather than the corporation. Since the district court below determined as a factual matter that "Lansdale transferred all his interest in the property to [Petitioner] on March 11, 1981 prior to sale of that property the next day . . ." (Pet. App. 9a), there is no basis for applying *Court Holding Co.* In essence, Petitioner simply disagrees with the district court's factual determination.

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[19] Petitioner also cites *Hines v. U.S.*, 477 F.2d 1063 (5th Cir. 1973). In *Hines*, however, the court determined that the assignment of income doctrine did not apply.

In sum, the courts below correctly determined that Petitioner is taxable on the gain it reported, and there is no reason for this Court to review their decision.

CONCLUSION

The decision below is correct, does not conflict with any precedent of this Court or, indeed, of any other court, and does not raise any issue of sufficient importance to warrant this Court's attention. Thus, no basis exists for granting the Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit. Respondent respectfully requests that the Petition be denied.

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APPENDIX

APPENDIX

IN THE DISTRICT COURT OF THE VIRGIN ISLANDS

DIVISION OF ST. THOMAS & ST. JOHN

CIVIL NOS. 86-263,
88-12 and 88-270

LA ISLA VIRGEN, INC.

Petitioner,

vs.

ANTHONY P. OLIVE, DIRECTOR VIRGIN ISLANDS BUREAU OF INTERNAL REVENUE

Respondent.

PETITIONS FOR REDETERMINATION OF INCOME TAX LIABILITY

MEMORANDUM IN SUPPORT OF VIBIR OPPOSITION TO PETITIONER'S MOTION FOR SUMMARY JUDGMENT AND RESPONDENT'S CROSS MOTION FOR SUMMARY JUDGMENT

COMES NOW, the Virgin Islands Bureau of Internal Revenue (VIBIR), by and through undersigned counsel, and respectfully requests that this Court deny the Petitioner's Motion for Summary Judgment and grant Respondent's Cross Motion for Summary Judgment. In support of its Opposition to petitioner's Motion and in further support of Respondent's Cross Motion for Summary Judgment the VIBIR submits the following memorandum.

I. SUMMARY OF ARGUMENT

It is the position of the Virgin Islands Bureau of Internal Revenue ("VIBIR") that the plain language of TRA 86 Section 1277(c)(2)(E) provides that LIV owes tax on its income from all sources to the VIBIR for the years at issue in this case. Section 1277(c)(2)(E), read together with the operative term "pre-1987 open year", defend at Section 1277(c)(2)(C) and construed by the Court of Appeals in *Danbury Inc. v. Olive*, 627 F. Supp. 513 (D.V.I. 1986), *rev'd* 820 F.2d 618 (3d Cir. 1987). *cert. denied* 484 U.S. 964 (1987), is contrary to LIV's claim of tax exemption. It is the position of the VIBIR that the statute is unambiguous. The result of LIV's exception from **retroactive** repeal is to hold LIV liable to the VIBIR for the pre-1987 tax years for which the VIBIR filed a deficiency notice within the statute of limitations, just as the Court of Appeals for the Third Circuit held in *Bizcap, Inc. v. Olive*, 892 F.2d 1163, 1164 (3d Cir. 1989) *cert. denied* ___ U.S. ___ (June 4, 1990). It is now beyond dispute that Section 28(a), the so called "inhabitant rule", never created any tax loophole and, that the targeted exceptions to **retroactive** repeal of the "inhabitant rule" did not give rise to a "tax haven" that never existed under a proper interpretation of prior law.

The timely statutory notices of deficiency issued by the VIBIR to LIV are attached as Petitioner's Exhibits 1, 2 and 3. As more fully set forth below, the VIBIR maintains that, with the exception of the installment sale and capital gain issues relative to the 1983 sale of the oil and gas property conceded below, the notices accurately calculate the income tax liability on worldwide income of LIV for the years at issue and properly assert the penalties owed under applicable statutes.

The VIBIR concedes that LIV may use the installment sale method in reporting the gain from the 1983 sale of LIV's oil and gas property based on the Third Circuit's

1990 decision in *Business Ventures International, Inc. v. Olive*, 893 F.2d 641 (3d Cir. 1990). In addition, the VIBIR concedes that LIV is entitled to calculate the income tax on this gain using rates applicable to capital gains.

The VIBIR requests that this Court affirm the VIBIR determination in all other respects.

* * *

IV. THE ASSESSMENT OF PENALTIES FOR FAILURE TO PAY TAX UNDER I.R.C. SECTION 6653(a) IS PROPER AND SHOULD BE SUSTAINED.

I.R.C. Section 6653(a)(1) imposes a penalty of 5 percent of any underpayment, as defined in subsection (c), of certain taxes, including income taxes, and which underpayment "is due to negligence or intentional disregard of rules and regulations (but without intent to defraud)." Subsection (a)(2), applicable to returns the due dates of which are prior to January 1, 1987, imposes an additional penalty equal to 50 percent of the interest on the underpayment described in subsection (a)(1) and running from the date the tax payment was due to the earlier of the date of assessment or payment of the tax.

The VIBIR assessed the penalty under I.R.C. section 6653(a)(1) and (2) for the fiscal years ended February 28, 1982, 1983, 1984, 1985, and 1986. (See Exhibits 1, 2, and 3.). The penalty was asserted due to LIV's failure to include non-Virgin Islands source income in taxable income as required by the Revised Organic Act of the V.I. of 1954. The addition to tax is presumptively correct and must stand unless the taxpayer can establish that the assessment of the penalty was erroneous. *Hall v. Commissioner*, 729 F.2d 632 (9th Cir. 1984). *Business Ventures International v. Olive*, 893 F.2d 641 (3d Cir. 1990). When a penalty is asserted under section 6653(a) the taxpayer has the burden to prove (1) that he was not negligent **and** (2) that he did not intentionally disregard rules or regu-

lations. *Business Ventures International* at 646; *Marcello v. Comm.*, 380 F.2d 499, 506 (5th Cir. 1967).

In reviewing the application of the 6653(a) penalty to the precise tax shelter scheme employed by LIV, the Court of Appeals for the Third Circuit has squarely held that disregard of Revenue Ruling 80-40 constitutes intentional disregard of a rule. *Business Ventures International* at 646.

LIV knowingly and intentionally disregarded rules and regulations when it filed its returns claiming that it was not required to pay tax on its income from sources outside the Virgin Islands. At the time LIV's returns were filed, Revenue Ruling 80-40 plainly precluded the taxpayer's treatment of its non-Virgin Islands source income. *Business Ventures International* at 646. See also *Island Acres, Inc. v. Olive*, 893 F.2d 647 (3d Cir. 1990) and *Affiliated Development Corp. v. Olive*, 893 F.2d 647 (3d Cir. 1990). LIV's advisor, Mr. Gustav A. Danielson repeatedly alerted the parties to the IRS Revenue Ruling 80-40, which was contrary to the reporting position that LIV was taking, in his opinion letter dated September 25, 1981. See Stipulation #67 and Exhibit 66 at pages 1, 13, 14 and 15. In the first paragraph of the September 25, 1981, opinion letter, Mr. Danielson plainly states that his legal opinion conflicts with revenue rulings and "in rare instances" regulations. Mr. Danielson stresses, "It is, therefore important that you recognize the Internal Revenue Service has taken a position contrary to our own and announced, formally, the policy which they intend to follow." See page 1 of Exhibit 66.

As noted by the Court in *Danbury*, the Internal Revenue Service had explained its reading of Section 28(a) of the Revised Organic Act in Revenue Ruling 80-40, 1980-1 C.B. 175. *Danbury* at 624. The issuance of rules and regulations is authorized by I.R.C. section 7805(a). Section 7805(b), "retroactivity of Regulations or Rulings," demonstrates

that the terms "rule" and "ruling" are used interchangeably in the statute. See *Business Ventures International* at 646.

Rev. Rul. 80-40 concluded that a V.I. inhabitant U.S. chartered corporation satisfied both its United States and Virgin Islands income tax obligations by paying the Virgin Islands income tax on its income from all sources. As Mr. Danielson advised LIV at page 6 of his opinion letter dated September 25, 1981, (Exhibit 66), this ruling was also the authority for the proposition that such a corporation could be an "inhabitant". See also page 7 of Exhibit 67. Pages 14 and 15 of the opinion at Exhibit 66 plainly prove LIV was advised of both the existence and holding of Rev. Rul. 80-40. The corporation chose to disregard this ruling and assume the risks of its tax avoidance scheme.

LIV has not alleged and can not produce any evidence that it did not intentionally disregard revenue ruling 80-40. Rather, LIV ignores the 1990 Third Circuit Court of Appeals decision in *Business Ventures International* which is on point and contrary to LIV's argument at pages 55 through 61 of its memorandum. Further, LIV flatly misstates the law as it relates to disclosure and intentional disregard of rules and regulations.

LIV baldly asserts at page 55 of its Memorandum that, "LIV's full disclosure should also preclude imposition of penalties for disregard of rules and regulations." This quite simply is not the law. The cases cited by LIV are inapposite.

The "intentional disregard" penalty of I.R.C. Section 6653(a) was designed to deter taxpayers from abusing prepayment deficiency procedures by intentionally underpaying and then contesting the deficiency. *Druker v. Comm.*, 697 F.2d 46, 54 (2d Cir. 1982), *cert. denied*, 103 S.Ct. 2429 (1983). If a taxpayer wishes to contest a "rule or regulation" without risk of penalty, his recourse is to pay the tax and then sue for refund. *Id.*

While the line between intentional disregard of rules or regulations on the one hand and fraud on the other hand may be fine, the line is nevertheless clear. That is, an intentional disregard of rules or regulations that is fully disclosed on the taxpayer's return and is not accompanied by affirmative acts of concealment, deceit, or misrepresentation is not fraudulent. See, *e.g.*, *Druker* at 53.

Beyond the issue of fraud, disclosure of the improper reporting position is irrelevant to the imposition of the penalty. In its thorough analysis of the intentional disregard standards under I.R.C. Sections 6653(a) and 6694(a), the Second Circuit noted in *Druker* that Congress had considered an alternative standard to the mandatory imposition of the addition under I.R.C. Section 6653(a) for intentional disregard. In 1954, the Senate Finance Committee proposed an amendment to I.R.C. Section 6653(a) that would have permitted a taxpayer who consciously disregards a rule or regulation to avoid the addition by attaching a statement to his return explaining the rules or regulations disregarded and the grounds on which he believes them invalid. S. Rep. No. 1622, 83rd Cong., 2d Sess. 591 (1954). This amendment was deleted in conference leaving in force the cases refusing to allow any reasonable cause defense where the addition was based on an intentional disregard of rules and regulations. See *Druker* at 54. The Court went on to distinguish I.R.C. Section 6694(a), which provides a "reasonable basis exemption" for good faith intentional disregard of a rule or regulation by a tax return *preparer*, and I.R.C. Section 6653(a) which provides no such exemption for a *taxpayer*. In holding the addition for intentional disregard under I.R.C. Section 6653(a) mandatory, the Court noted that the construction of this section has been settled since 1942. *Id.* at 55.

Clearly, *Druker v. Comm.*, 697 F.2d 46, 53-54 (2d. Cir. 1982), *cert. denied*, 103 S.Ct. 2429 (1983), is contrary to LIV's assertion that disclosure negates the penalty under I.R.C. Section 6653(a) (Reasonableness of taxpayers action

may be relevant when he is charged with negligence, but not when he has admittedly flouted applicable rules and regulations which he fully understood). Disclosure distinguishes intentional disregard of rules and regulations under I.R.C. Section 6653(a) from civil fraud under I.R.C. Section 6653(b). See *Raley v. C.I.R.*, 676 F.2d 980, 983 n. 7 (3d Cir. 1982). Citing *Druker* and *Raley* the Tenth Circuit has also recognized this distinction stating;

> Thus, under traditional definitions of fraud, disclosed defiance of the tax laws is not fraudulent. Rather it is intentional disregard of the rules and regulations—an offense for which Congress has expressly provided a penalty under section 6653(a). . . . The interrelation of sections 6653(a) and (b) makes it clear that the civil fraud provision does not reach mere intentional disregard of rules and regulations. *Zell v. Comm.*, 763 F.2d 1139, 1144 (10th Cir. 1985).

The BIR respectfully submits that LIV's alleged "disclosure" is irrelevant to imposition of the penalty under Section 6653(a). As more fully set forth in the discussion of disclosure under the Section 6661 penalty below, it is the VIBIR's position that the tax returns filed by LIV did not disclose LIV's participation in the "28(a) tax shelter" scheme. LIV's view of the law with regard to intentional disregard of rules and regulations is contrary to the interpretations of at least three Circuit Courts of Appeal. LIV's authority for its proposition are outdated, distinguishable and do not support the proposition urged upon this Court.

LIV could only avoid the section 6653(a) penalty if it established that it did not intentionally disregard Revenue Ruling 80-40. *Business Ventures International* at 646. The record is clear that LIV consciously chose to disregard the ruling. The law of this Circuit under these facts and circumstances is clear and unassailable. The penalty applies as a matter of law. *Id.*

LIV is also required to prove that it was not negligent in its claimed reporting position. Negligence is determined by the reasonable, prudent person standard. *Zmulda v. Comm.*, 731 F.2d 1417 (9th Cir. 1984). LIV has claimed reliance on counsel as its defense to the assertion of negligence. To overcome a negligence penalty the taxpayer must prove not only that he relied on competent counsel, but also, that such reliance was reasonable and in good faith. *Ward v. Comm.*, 47 T.C.M. (CCH) 588 (1983), *Preston v. Comm.*, 47 T.C.M. (CCH) 417 (1983).

LIV has not produced evidence that it reasonably relied on competent counsel. The evidence offered by the Petitioner in this case to disprove negligence are the opinions of Gustav Danielson. Established case law places a greater burden on the taxpayer to establish **reasonable** reliance.

In this regard, it has been held than an investor was liable for negligence penalties because he could not have reasonably relied upon the advice of promoters or persons who the promoters introduced to the taxpayer as "tax professionals" because those persons were not independent of the promoters. His reliance on their advice was not reasonable because of his failure to obtain independent advice from tax professionals not connected with the shelter. *Bilyeu v. Comm.*, 55 T.C.M. (CCH) 836 (1988). Here, LIV sought the opinion of the author of the "28(a) tax haven theory" whose advice and predisposition were known from the "portfolio." (See paragraphs 3. and 5. of the Affidavit of Stephen L. Newman at Exhibit 64.) Mr. Danielson was retained to incorporate LIV and became its first president. Rex Danielson, his son, served as Secretary, Treasurer and Director of LIV from March 1981 through all years at issue in this proceeding. (See Stipulation #7.) The VIBIR submits that Mr. Gustav A. Danielson was not independent of the promoter—he was the promoter.

The penalty has been sustained in the face of similar facts where the petitioner testified that he sought advice from an attorney or an accountant, but there was no evidence that either an attorney or an accountant advised the petitioner that the scheme would produce the desired tax advantages. *Brown v. Comm.*, 43 T.C.M. (CCH) 1322, 1324 (1982). In *Brown*, which involved a "family trust", considering that both petitioners were well educated, the Court found it difficult to believe that they could have envisioned the Trust as anything other than a flagrant tax avoidance scheme. Id.

The opinions proffered by LIV contain numerous caveats and potential problems associated with the " 28(a) tax haven theory." See Exhibits 66, pages 13 through 18, and 67 pages 3 and 9. To the extent that one could draw a reasonable conclusion from these documents, it was that the entire scheme was subject to attack on numerous grounds, would certainly be challenged by the taxing authorities and was unlikely to survive judicial review. Indeed, Mr. Danielson's letter to Governor King in 1975, at Exhibit 68, and his previously published work, at Exhibit 69, reach the same conclusion as that asserted by the VIBIR in its deficiency notices—the position upheld by the Court of Appeals in *Danbury*.

LIV has failed to meet its burden of proof to disprove both intentional disregard of Rev. Rul. 80-40 and negligence. On the record in this case, the penalty applies as a matter of law.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 91-3202

LA ISLA VIRGEN, INC.,
Petitioner - Appellant

vs.

ANTHONY P. OLIVE, Director of Virgin Islands Bureau of Internal Revenue, and GOVERNMENT OF THE VIRGIN ISLANDS,
Respondents - Appellees

ON APPEAL FROM THE DISTRICT COURT OF THE VIRGIN ISLANDS DIVISION OF ST. THOMAS AND ST. JOHN
(D.C. Nos 86-263, 88-12, and 88-270)

BRIEF ON BEHALF OF ANTHONY P. OLIVE, ETC., RESPONDENTS - APPELLEES

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I. SUBJECT MATTER AND APPELLATE JURISDICTION

This appeal results from the determination of the District Court of the Virgin Islands that the income tax deficiencies assessed by Respondent-Appellee Anthony P. Olive, then Director of the Virgin Islands Bureau of Internal Revenue, Government of the Virgin Islands (hereinafter referred to as "VIBIR") against Petitioner-Apellant La Isla Virgen, Inc. (hereinafter referred to as "LIV") were correct.

The matter was properly before the District Court of the Virgin Islands, Division of St. Thomas and St. John, pursuant to section 994, Title 33, Virgin Islands Code, and Section 1612(a), Title 48, U.S.C. This court has Appellate jurisdiction pursuant to section 1613(c), Title 48, U.S.C. The appeal is from a final judgment in accordance with section 1291, Title 28, U.S.C.

II. ISSUES PRESENTED FOR REVIEW

Petitioner-Appellant has raised the following issues for review:

1. Whether the District Court erred in determining that Section 1277(c)(2)(E) of the Tax Reform Act of 1986 (hereinafter referred to as "TRA 86") does not bar the VIBIR from assessing income tax liability against LIV with respect to income attributable to transactions specified in that statute.

2. Whether the District Court erred in determining that the redemption and disposition of certain limited partnership interests in 1981 and 1983 are properly characterized as a sale by LIV.

3. Whether the District Court erred in adopting the VIBIR's recharacterization of the transactions without applying a step transaction analysis to support its determination that the redemption and dispositions of limited partnership interests constituted a taxable sale by LIV.

4. Whether the District Court erred in finding that gain attributable to the redemption and disposition of limited partnership interests does not qualify for the alternative tax rate on capital gains.

5. Whether the District Court erred in determining that LIV is liable for penalties under sections 6651, 6653, and 6661 of the Internal Revenue Code (hereinafter the "IRC").

III. STATEMENT OF THE CASE

The case involves the District Court's grant of the VIBIR's Cross-Motion for Summary Judgment and resulting determination of deficiencies in taxes as to LIV for the years 1981, 1982, 1983, 1984, and 1985 and deficiencies for penalties under IRC sections 6651, 6653, and 6661 (and denial of LIV's Motion for Summary Judgment). LIV filed its Notice of Appeal on March 27, 1991, and this proceeding follows.

IV. STATEMENT OF FACTS

The VIBIR and LIV filed a 29-Page Stipulation of Facts (hereinafter the "Stipulation"), Appendix pp. 315A-343A,

with the District Court on October 29, 1990, which sets out the facts upon which the VIBIR's Cross-Motion for Summary Judgment and this brief are based.

V. STATEMENT OF RELATED CASES

No other cases are presently on appeal to this Court or docketed in the District Court of the Virgin Islands involving the issue of the authority of the Virgin Islands to tax a U.S. corporation which is an "inhabitant" of the Virgin Islands pursuant to 48 U.S.C. section 1642, where the corporation has been granted a targeted exception by the Tax Reform Act of 1986. This case also involves the application of certain principles of Federal income tax law to certain transactions. The VIBIR does not know whether any other cases involving these issues are presently on appeal to this Court or docketed in the District Court of the Virgin Islands.

VI. STANDARD FOR REVIEW

LIV contends that the District Court erred in formulating or applying the law, and that review by this Court of the questions of interpretation and application of the law is plenary. (Citing cases including *Minizza v. Stone Container Corp.*, 842 F.2d 1456, 1459 (3d Cir. 1988). The VIBIR disagrees with this contention of error and agrees with the formulation and application of the law by the District Court, except in the District Court's failure to find that LIV intentionally disregarded income tax rules as one basis for imposing penalties under IRC section 6653(a). However, the VIBIR agrees with the LIV assertion of the standard for review herein.

VII. SUMMARY OF ARGUMENT

It is the VIBIR's position that the plain language of TRA 86 Section 1277(c)(2)(E) provides that LIV owes tax on its income from all sources to the VIBIR for the years

at issue in this case. TRA 86 Section 1277(c)(2)(E), read together with the operative term "pre-1987 open year," defined at Section 1277(c)(2)(C), and construed by the Third Circuit Court of Appeals in *Danbury Inc. v. Olive*, 627 F. Supp. 513 (D.V.I. 1986), *rev'd* 820 F.2d 618 (3d Cir. 1987). *cert. denied* 484 U.S. 964 (1987), is contrary to LIV's claim of tax exemption. The statute is unambiguous. The result of LIV's exception from retroactive repeal is to hold LIV liable to the VIBIR for the pre-1987 tax years for which the VIBIR filed a deficiency notice within the statute of limitations, just as the Court of Appeals for the Third Circuit held in *Bizcap, Inc. v. Olive*, 892 F. 2d 1163, 1164 (3d Cir. 1989) *cert. denied* ___ U.S. ___ (June 4, 1990). It is now beyond dispute that Section 28(a), the so-called "inhabitant rule", never created any tax loophole and that the targeted exceptions to retroactive repeal of the "inhabitant rule" did not give rise to a "tax haven" that never existed under a proper interpretation of prior law.

The VIBIR issued timely statutory notices of deficiency. As more fully set forth below, the VIBIR maintains that with the exception of the installment sale and capital gain issues relative to the 1983 sale of the oil and gas property conceded in its Cross-Motion for Summary Judgment in the District Court, the notices accurately calculate the income tax liability on worldwide income of LIV for the years at issue and properly assert the penalties owed under applicable statutes.

The VIBIR requests this Court affirm the determination of the District Court in all respects, and that the Court also determine that the VIBIR can assess the penalty under

IRC section 6653(a) based on LIV's intentional disregard of the applicable income tax rules and regulations.

* * *

X. THE ASSESSMENT OF PENALTIES FOR FAILURE TO PAY TAX UNDER IRC SECTION 6653 (a) WAS PROPERLY SUSTAINED BY THE DISTRICT COURT, BUT THE VIBIR REQUESTS THE COURT OF APPEALS TO ALSO FIND INTENTIONAL DISREGARD.

IRC Section 6653(a)(1) imposes a penalty of five percent of any underpayment, as defined in subsection (c), of certain taxes, including income taxes, and which underpayment "is due to negligence or intentional disregard of rules and regulations (but without intent to defraud)." Subsection (a)(2), applicable to returns with due dates prior to January 1, 1987, imposes an additional penalty equal to 50 percent of the interest on the underpayment described in subsection (a)(1) running from the date the tax payment was due to the earlier of the date of assessment or payment of the tax.

The VIBIR assessed the penalty under I.R.C. section 6653(a)(1) and (2) for the fiscal years ended February 28, 1982, 1983, 1984, 1985, and 1986. The penalty was asserted due to LIV's failure to include non-Virgin Islands source income in taxable income as required by the Revised Organic Act of the V.I. of 1954. The addition to tax is presumptively correct and must stand unless the taxpayer can establish that the assessment of the penalty was erroneous. *Hall v. Commissioner*, 729 F.2d 632 (9th Cir. 1984); *Business Ventures International v. Olive*, 893 F.2d 641 (3d Cir. 1990). When a penalty is asserted under section 6653(a) the taxpayer has the burden to prove (1) that he was not negligent and (2) that he did not intentionally disregard rules and regulations. *Business Ventures International* at 646; *Marcello v. Comm.*, 380 F.2d 499, 506 (5th Cir. 1967).

The District Court held that the record does not support a finding of intentional disregard of rules and regulations. The VIBIR disagrees with this finding and respectfully requests this Court to take plenary review of the District Court's holding in this matter and to determine that the taxpayer demonstrated an intentional disregard of rules and regulations in the present case as well as negligence. There is ample authority to support such a finding by this court. Specifically, in reviewing the application of the IRC 6653(a) penalty to the precise tax shelter scheme employed by LIV, this Court has squarely held that disregard of Revenue Ruling 80-40 constitutes intentional disregard of a rule. *Business Ventures International* at 646.

LIV knowingly and intentionally disregarded rules and regulations when it filed its returns claiming that it was not required to pay tax on its income from sources outside the Virgin Islands. At the time LIV's returns were filed, Revenue Ruling 80-40 clearly and unambiguously precluded the taxpayer's treatment of its non-Virgin Islands source income. *Business Ventures International* at 646. *See also Island Acres, Inc. v. Olive*, 893 F.2d 647 (3rd Cir. 1990) and *Affiliated Development Corp. v. Olive*, 893 F.2d 647 (3d Cir. 1990). LIV's advisor, Mr. Gustave A. Danielson, repeatedly alerted the parties to the IRS Revenue Ruling 80-40, which was contrary to the reporting position that LIV was taking, in his opinion letter dated September 25, 1981. *See* Stipulation #67, Appendix p. 341A. In the first paragraph of the September 25, 1981, opinion letter, Mr. Danielson plainly states that his legal opinion conflicts with revenue rulings and "in rare instances" regulations. Appendix p. 867A. Mr. Danielson stresses, "It is, therefore, important that you recognize the Internal Revenue Service has taken a position contrary to our own and announced, formally, the policy which they intend to follow." As noted by the court in *Danbury*, the Internal Revenue Service had explained its reading of Section 28(a) of the ROA in Revenue Ruling 80-40, 1980-1 C.B. 175. *Danbury* at 624.

The issuance of rules and regulations is authorized by I.R.C. section 7805(a). I.R.C. Section 7805(b), Retroactivity of Regulations or Rulings, demonstrates that the terms "rule" and "ruling" are used interchangeably in the statute. *See Business Ventures International* at 646.

Rev. Rul. 80-40 concluded that a V.I. inhabitant U.S. chartered corporation satisfied both its United States and Virgin Islands income tax obligations by paying the Virgin Islands income tax on its income from all sources. As Mr. Danielson advised LIV at page 6 of his opinion letter dated September 25, 1981, this ruling was also the authority for the proposition that such a corporation could be an "inhabitant." Pages 14 and 15 of the opinion plainly prove LIV was advised of both the existence and holding of Rev. Rul. 80-40. Appendix pp. 880A-881A. The corporation chose to disregard this ruling and assume the risks of its tax avoidance scheme.

LIV has not alleged and can not produce any evidence that it did not intentionally disregard Revenue Ruling 80-40. Rather, LIV and the District Court below ignore the 1990 Third Circuit Court of Appeals decision in *Business Ventures International.*

The "intentional disregard" penalty of I.R.C. Section 6653(a) was designed to deter taxpayers from abusing prepayment deficiency procedures by intentionally underpaying and then contesting the deficiency. *Druker v. Comm.*, 697 F.2d 46, 54 (2nd Cir. 1982), *cert. denied*, 103 S.CT. 2429 (1983). If a taxpayer wishes to contest a "rule or regulation" without risk of penalty, his recourse is to pay the tax and then sue for refund. *Id.*

While the line between intentional disregard of rules or regulations on the one hand and fraud on the other hand may be fine, the line is nevertheless clear. That is, an intentional disregard of rules or regulations that is fully disclosed on the taxpayer's return and is not accompanied

by affirmative acts of concealment, deceit, or misrepresentation is not fraudulent. *See e.g., Druker* at 53.

Beyond the issue of fraud, disclosure of the improper reporting position is irrelevant to the imposition of the penalty. In its thorough analysis of the intentional disregard standards under I.R.C. Sections 6653(a) and 6694(a), the Second Circuit noted in *Druker* that Congress had considered an alternative standard to the mandatory imposition of the addition under I.R.C. Section 6653(a) for intentional disregard. In 1954, the Senate Finance Committee proposed an amendment to I.R.C. Section 6653(a) that would have permitted a taxpayer who consciously disregards a rule or regulation to avoid the addition by attaching a statement to this return explaining the rules or regulations disregarded and the grounds on which he believes them invalid. S. Rep. No. 1622, 83rd Cong., 2d Sess. 591 (1954). This amendment was deleted in conference leaving in force the cases refusing to allow any reasonable cause defense where the addition was based on an intentional disregard of rules and regulations. *See Druker* at 54. The Court went on to distinguish I.R.C. Section 6694(a), which provides a "reasonable basis exemption" for good faith intentional disregard of a rule or regulation by a tax return *preparer*, and I.R.C. Section 6653(a) which provides no such exemption for a taxpayer. In holding the addition for intentional disregard under I.R.C. Section 6653(a) mandatory, the Court noted that the construction of this section has been settled since 1942. *Id.* at 55.

Clearly, *Druker v. Comm.*, 697 F.2d 46, 53-54 (2d. Cir. 1982), *cert. denied*, 103 S.Ct. 2429 (1983), is contrary to LIV's assertion that disclosure negates the penalty under I.R.C. Section 6653(a). Disclosure distinguishes intentional disregard of rules and regulations under I.R.C. Section 6653(a) from civil fraud under I.R.C. Section 6653(b). *See Raley v. C.I.R.*, 676 F.2d 980, 983 n.7 (3rd Cir. 1982). *Citing Druker* and *Raley*, the Tenth Circuit has also recognized this distinction stating:

> Thus, under traditional definitions of fraud, disclosed defiance of the tax laws is not fraudulent. Rather it is intentional disregard of the rules and regulations—an offense for which Congress has expressly provided a penalty under section 6653(a) . . .

The interrelation of IRC sections 6653(a) and (b) makes it clear that the civil fraud provision does not reach mere intentional disregard of rules and regulations. *Zell v. Comm.*, 763 F.2d 1139, 1144 (10th Cir. 1985).

The BIR respectfully submits that LIV's alleged "disclosure" is irrelevant to imposition of the penalty under IRC Section 6653(a). As more fully set forth in the discussion of disclosure under the IRC Section 6661 penalty below, it is the VIBIR's position that the tax returns filed by LIV did not disclose LIV's participation in the "28(a) tax shelter" scheme. LIV's view of the law with regard to intentional disregard of rules and regulations is contrary to the interpretations of at least three Circuit Courts of Appeal. LIV's authority for its proposition are outdated, distinguishable, and simply do not support the proposition urged upon this Court.

LIV could only avoid the section 6653(a) penalty if it is established that it did not intentionally disregard Revenue Ruling 80-40 and was not negligent in its reporting position. *Business Ventures International* at 646. The record is clear that LIV consciously chose to disregard the ruling. The law of this Circuit under these facts and circumstances is clear and unassailable. The penalty applies as a matter of law. *Id.* Moreover, since LIV is also required to prove it was not negligent in its reporting position under the reasonable, prudent person standard (*Zmulda v. Comm.*, 731 F.2d 1417 (9th Cir. 1984)), it must prove not only reliance on competent counsel, but also that such reliance was reasonable and in good faith. *Ward v. Comm.*, 47 T.C.M. (CCH) 588 (1983), *Preston v. Comm.*, 47 T.C.M. (CCH) 417 (1983).

LIV has not produced evidence that it reasonably relied on competent counsel. The evidence offered by the Petitioner-Appellant in this case to disprove negligence are the opinions of Gustave Danielson. Established case law places a greater burden on the taxpayer to establish reasonable reliance.

In this regard, it has been held that an investor was liable for negligence penalties because he could not have reasonably relied upon the advice of promoters or persons who the promoters introduced to the taxpayer as "tax professionals" because those persons were not independent of the promoters. His reliance on their advice was not reasonable because of his failure to obtain independent advice from tax professionals not connected with the shelter. *Bilyeu v. Comm.*, 55 T.C.M. (CCH) 836 (1988). Here, LIV sought the opinion of the author of the "28(a) tax haven theory" whose advice and predisposition were known from the "portfolio." *See* paragraphs 3 and 5 of the Affidavit of Stephen L. Newman, Appendix p. 860A. Mr. Danielson was retained to incorporate LIV and became its first president. Appendix p. 518A. Rex Danielson, his son, served as Secretary, Treasurer, and Director of LIV from March 1981 through all years at issue in this proceeding. Stipulation 7, Appendix 318A. The VIBIR submits that Mr. Gustave A. Danielson was not independent of the promoter—he was the promoter.

The penalty has been sustained in the face of similar facts where the petitioner testified that he sought advice from an attorney or an accountant, but there was no evidence that either an attorney or an accountant advised the petitioner that the scheme would produce the desired tax advantages. *Brown v. Comm.*, 343 T.C.M. (CCH) 1322, 1324 (1982). In *Brown*, which involved a "family trust," in considering that both petitioners were well educated the Court found it difficult to believe that they could have envisioned the Trust as anything other than a flagrant tax avoidance scheme. *Id.*

The opinions proffered by LIV contain numerous caveats and potential problems associated with "28(a) tax haven theory." To the extent that one could draw a reasonable conclusion from these documents, it was that the entire scheme was subject to attack on numerous grounds, would certainly be challenged by the taxing authorities and was unlikely to survive judicial review. Indeed, Mr. Danielson's letter to Governor King in 1975, Appendix p. 896A, and his previously published work (Affidavit of Stephen L. Newman, Appendix p. 860A) reach the same conclusion as that asserted by the VIBIR in its deficiency notices—the position upheld by the Court of Appeals in *Danbury*.

LIV has failed to meet its burden of proof to disprove both intentional disregard of Rev. Rul. 80-40 and negligence. On the record in this case, the penalty applies as matter of law.